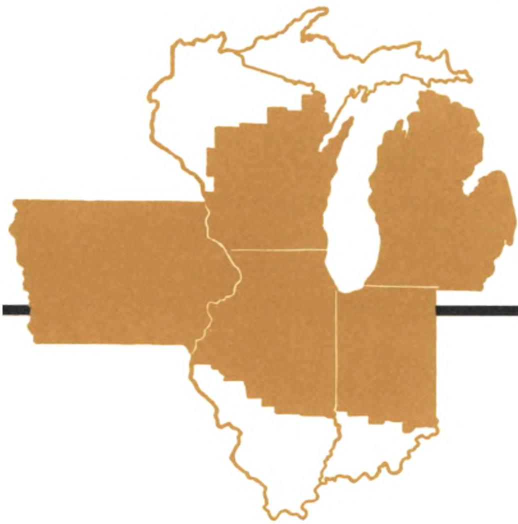
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1964 January

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1963—third year of expansion

As is wont to happen near the beginning of each year, recent weeks have brought forth a succession of projections of probable economic activity in the year ahead. Most are in close agreement on fundamentals. The estimates of total income or production—gross national product (GNP)—for 1964 tend to cluster within a range of 615 to 620 billion dollars, compared with an estimated 585 billion dollars for 1963. By year-end, the 615 billion figure had become virtually the "standard forecast" for 1964.

Several of the projections are summarized in the table below. All of these, it should be noted, assume that the proposed reductions in Federal taxes will be adopted and made effective as of the first of the year and that there will be an appreciable movement in price levels.

On balance, the implied 5 to 6 per cent rise in GNP spells continuation of expansion under way since early 1961. Whether this will in fact be the business profile for 1964 is, of course, for the future to tell. In the meantime, a review of developments in the year just past, and in earlier stages of the uptrend, may be an aid in evaluating the plausibility of a family of generally reassuring projections.

Economic activity had been expanding for almost three years as 1963 drew to a close. The duration and extent of the climb from the 1960-61 recession considerably surpasses the performance following the 1957-58 contraction (see *Business Conditions*, August 1963). The overall rise in gross national product since the first quarter of 1961 amounts to about 100 billion dollars, or 20 per cent in less than three years—with about four-fifths of the gain a result of increased production and one-fifth the effect of higher prices.

The 1963 increase was on the order of 28 to 30 billion dollars, with estimates of GNP close to 600 billion dollars (at an annual rate) for the final quarter of the year. The expansion during the year—as well as in 1961 and 1962—was the result of higher demand in all three major sectors: businesses,

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Projections of gross national product for 1964

Source	GNP (billion dollars)
Prudential Insurance Company	617
University of Michigan (econometric model)	619
Moody's Stock Survey	615
National Planning Association	609-612
McGraw-Hill Department of Economics	615
Standard and Poor's Corporation	615

consumers and governments. The ability of the economy to absorb rising expenditures was demonstrated by continuation of the relative price stability that has characterized the years since 1957.

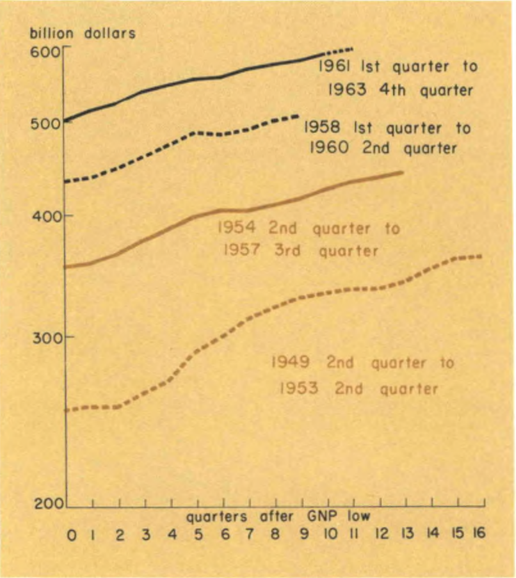
Price stability in the face of high-level and rising activity to a large extent reflects the persistence of slack in the utilization of manpower and other resources. During 1963, an average of more than 4 million persons—between 5.5 and 6 per cent of the civilian labor force—were out of work. It is widely agreed that this was far greater than the number of persons "normally" idle in a changing and growing economy. The inability of many workers, in addition to the seasonally or otherwise temporarily unemployed, to find jobs remains one of the nation's most vexing economic and social problems.

Major strikes in basic industries were avoided in 1963. The possibility of a stoppage in the steel industry led to some precautionary inventory investment early in the year. Subsequent reductions in inventory holdings, however, occurred in an orderly fashion during the summer months. Steel production declined in the third quarter but increased toward year-end as manufacturers of durable goods began rebuilding inventories to keep abreast of advancing output and sales.

The political climate was comparatively calm during 1963 by contrast with earlier postwar years when major international crises had occurred. The assassination of President Kennedy in late November, however, had severe shock effects: retail sales contracted sharply but recovered in early December; the impact in financial centers, both domestic and overseas, was also of short duration. The orderly transfer of government powers did much to restore consumer and business confidence.

Personal consumption expenditures increased about 5 per cent in 1963. During the third quarter they were at an estimated an-

Gross national product in four postwar expansions



nual rate of 375 billion dollars, compared with 357 billion a year before. Spending on durables increased more than spending on non-durables. Retail sales of auto dealers and stores handling other durable goods increased nearly 7 per cent in the 12 months ended November 1963. During the same period, sales of stores handling food, clothing and other "soft" goods rose 4 per cent.

Consumers added a record 6 billion dollars to their short- and intermediate-term instalment debt in the 12 months ended October 1963. This rise continued the long growth of this type of indebtedness that has been a conspicuous feature of the postwar years. The ratio of debt repayment to disposable income approached 14 per cent during the year —narrowly higher than its previous postwar peak in early 1961.

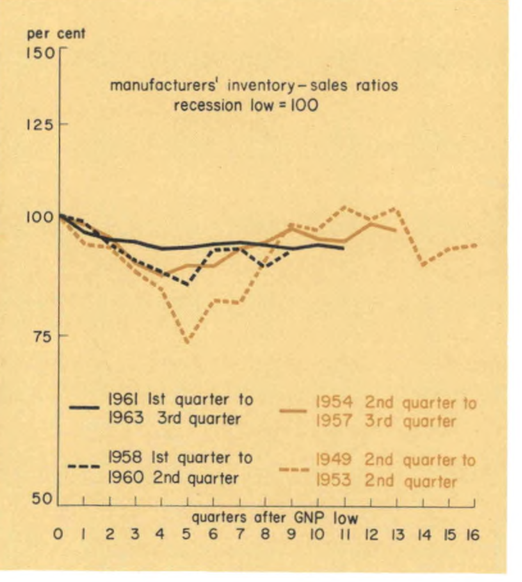
Private construction, including expenditures on residential structures and farm buildings, was nearly 5 per cent above 1962. The sustained rise in homebuilding activity during the recent expansion is quite different from experience in the same phases of the prior two postwar business cycles. In these, residential construction topped out and turned down after six or seven quarters.

Outlays for business plant and equipment declined slightly toward the end of 1962 and in early 1963. Thereafter they moved upward, climbing an estimated 11 per cent between the first quarter and the fourth, in which they reached a record annual rate of 41 billion dollars.

Corporate profits before Federal income taxes appear certain to have surpassed the 47 billion dollar figure for 1962. In the third quarter of 1963, corporate earnings were at an annual rate of 52 billion dollars—the highest since 1959. The continued rise of profits in the current expansion differs greatly from experience in earlier postwar upturns, when profits peaked out in the sixth or seventh quarter and then turned down.

Total cash flow (retained earnings plus de-

Stability in inventories marks present expansion



Recent employment gains in three District states match nation but earlier declines were sharper

	Expansion		Recession
	Oct. 1962 to Oct. 1963	Feb. 1961 to Oct. 1963	May 1960 to Feb. 1961
	(per cent change)		
United States.	2	11	−4
Illinois.	1	8	−5
Indiana.	2	12	−6
Michigan	2	13	−8
Wisconsin . . .	2	12	−6

preciation allowances) to corporations appears to have increased more rapidly than profits—largely owing to liberalized tax treatment of depreciation charges and investment outlays. Retained earnings in the third quarter of 1963 were at an annual rate of just under 10 billion dollars and total depreciation, almost 33 billion dollars.

Government purchases of goods and services rose about 7 per cent in 1963 with state and local spending—which has grown about 4 billion dollars annually in recent years—increasing more than Federal expenditures. Federal spending leveled off in the third quarter of 1963 but the 1.25 billion dollar increase in military pay boosted spending in the final quarter. The second phase of the civilian pay raise is expected to add an additional half billion dollars to expenditures in the first quarter of 1964.

The ratio of business inventories to sales has gradually declined in the present business expansion. By the end of 1963, no indication had appeared that stocks in the hands of manufacturers and merchants had reached burdensome proportions. Inventories are one of the more sensitive economic indicators. A climb in the ratio of total holdings to sales often can be interpreted as a portent of future slowing in the stream of new orders and thus the level of productive activity.

Consumer prices increased in 1963 by slightly more than 1 per cent. Prices of services, such as personal care and hospital and other medical care, increased considerably more than prices of goods. Many observers believe that recent moderate increases in consumer prices have largely reflected improvements in product quality and on this account have not been indicative of excessive inflationary pressures.

Wholesale prices, as an average covering a broad group of commodities, changed little in 1963. Monthly indexes for the year were at or narrowly below year-earlier levels. Prices at the wholesale level have remained quite stable throughout the current business expansion and, indeed, during the past six years. Keen competition, partly from imports, has been a stabilizing influence. Changes that have taken place mostly reflect shifts in market demands, with increases for some goods offsetting declines for others. Thus, prices of steel, aluminum, chemicals and paper increased in 1963 while prices of cement, hides, rubber and meat animals declined.

Business conditions in the five *Seventh Federal Reserve District states* registered substantial improvement during the past year. Such durable goods as motor vehicles and parts, iron and steel and a wide variety of machinery are important products in the area and output gains in indus-

Industries important to Midwest show gains in expansion after substantial cutbacks earlier

U.S. total	Expansion: Oct. 1962 to Oct. 1963	Expansion: Feb. 1961 to Oct. 1963	Recession: May 1960 to Feb. 1961
	(per cent change*)		
Industrial production	**6**	**22**	**−5**
Motor vehicles and parts	11	63	−26
Iron and steel	10	28	−26
Nonelectrical machinery	11	35	−8
Electrical machinery	5	23	−6

*Changes in Federal Reserve indexes of industrial production.

tries supplying them have in general outpaced the growth in overall industrial production. Activity in these key midwestern industries, on the other hand, had declined more sharply than total industrial production during the 1960-61 business contraction.

Of the four major industrial states in the Seventh District, only Illinois has registered employment growth at a slower pace than the nation as a whole since 1960. All four states, however, had experienced more severe curtailments in nonfarm wage and salary employment during the immediately preceding recession than was evident in the nation.

Moreover, the relatively mature durables manufacturing states of the Midwest appear to have lagged somewhat behind the nation since about 1957, in employment and income growth. This has reflected partly a shift in defense procurement—from Midwest area suppliers to firms located elsewhere—and partly the "naturally" higher rates of development all but inevitable in sections of the country that had only reached the stage of rapid population growth and industrialization after World War II ended.

Banking trends

MONETARY POLICY in 1963 continued to be generally conducive to business expansion. Bank deposits and credit rose sharply, continuing a trend begun in mid-1960.

Owing both to the pace of improvement in business conditions during the year and to deterioration in the nation's balance of international payments in the first two quarters, the monetary and credit climate, however, was somewhat less easy in 1963 than it had been in 1962. Total bank reserves—adjusted for both seasonal changes and changes in reserve requirements—expanded 2 per cent in the first 11 months of 1963 compared with almost 2.7 per cent in the corresponding period of 1962.

A greater proportion of the increase in reserves was provided through the discount window in 1963 than the year before, and the banks utilized their reserves more fully by reducing excess reserves. As a consequence, free reserves (excess reserves less borrowings) declined from almost 500 million dollars in November 1962 to about 50 million dollars a year later. Viewed against the backdrop of a rise in total reserves, the decline in free reserves indicates that commercial banks used more reserves than the Federal Reserve supplied through open market operations.

The seasonally adjusted money supply (private demand deposits and currency outside of banks) increased almost 3.5 per cent in the first 11 months of 1963. This compares with a rise of less than 1 per cent in the comparable period a year earlier. Nevertheless, growth in the money supply was not as rapid as the expansion in gross national product, and the ratio of money supply to GNP—which has been declining since World War II—dropped to a postwar low of 24.9 per cent in the third quarter of the year.

Time and savings deposits at commercial banks rose 13.4 per cent in the first 11 months of 1963, only slightly less than the record 16.1 per cent gain in the corresponding months a year earlier. In 1962, deposit growth was stimulated by the increases in interest rates that occurred after the maximum rates that banks are permitted to pay were raised in most areas at the beginning of the year.

The flow of funds to banks through the sale of time certificates of deposit (CDs) was given a boost in midyear when banks were granted permission to pay up to 4 per cent interest on 3- to 12-month certificates. Previously, they had been permitted to pay only 2½ per cent on 3- to 6-month CDs and 3½ per cent on those maturing in 6 to 12 months. A substantial proportion of CDs sold after midyear had maturities of between 3 and 6 months.

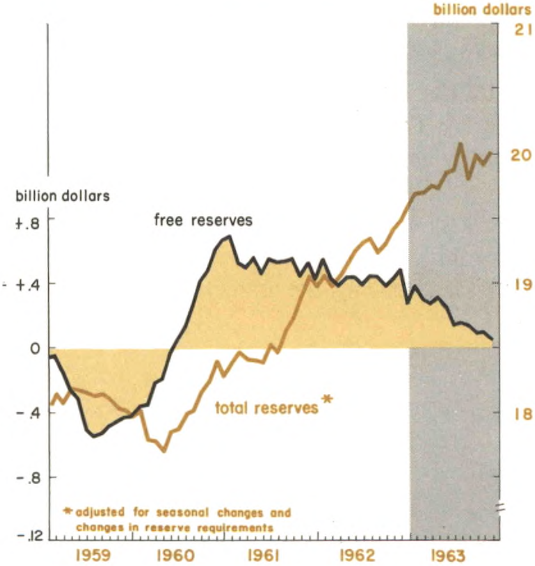
Loans rise rapidly

Within the total rise in bank holdings of earning assets associated with deposit growth in 1963, gains in loans and holdings of state and local government obligations were predominant. The increase in loans surpassed the previous record gain in 1959. At the end of November, loans outstanding were 16.5 billion dollars higher than a year earlier and greater in relation to deposits than at any previous time in the postwar period.

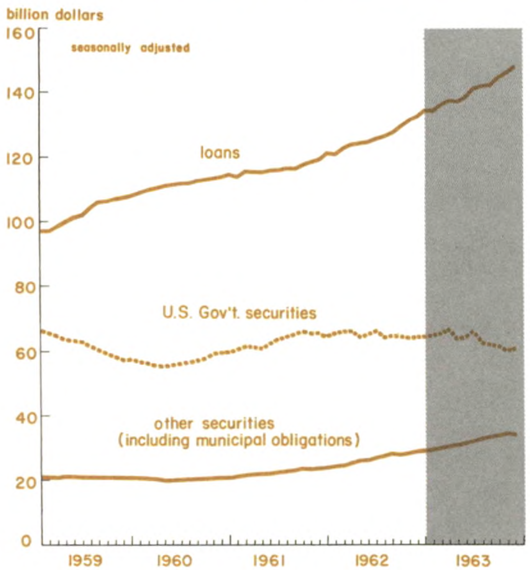
Holdings of real estate and consumer loans continued to expand at a rapid pace during the year. Mortgage loans of all banks in the United States rose a record 4.9 billion dollars in the 11 months ending with November, while consumer loans rose 2.9 billion dollars.

Loans to business firms, however, responded rather sluggishly to the improvement in economic conditions, rising only slightly more than in 1962 and only about half as much as in 1959—another period of rapid

Total reserves continued to expand in 1963 although free reserves declined



Commercial banks expanded loans and municipal holdings in 1963 while reducing U. S. securities



economic expansion. In part, the relatively slow rise in 1963 may reflect the large volume of internally generated funds available to corporations during the year as well as an increase in nonbank borrowing—by the issuance of long-term debt and commercial paper —and the sale of equities (see *Business Conditions,* October 1963).

Business loans advanced more rapidly in the Seventh District than in the country as a whole, expanding 7.6 per cent at large banks in major District centers in the first 11 months of the year. This compares with 5.3 per cent at large banks in all major cities of the nation.

Portfolios of tax-exempt state and local obligations expanded 4.8 billion dollars in the first 11 months of 1963, only slightly less than the increase of 4.9 billion in the same period a year before and considerably more than the 2.4 billion gain in 1958, the year of greatest expansion in municipal securities until 1962.

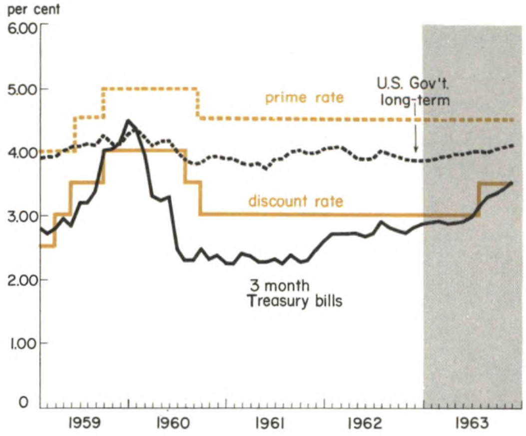
Bank holdings of U. S. Treasury securities declined 4.4 billion dollars in the first 11 months of 1963. This compares with a much smaller reduction in the same months of 1962 and increases in 1960 and 1961. As shown below, almost all of the reductions were in short-term maturities which at the larger banks declined sharply as a proportion of the total Treasury securities portfolio.

Maturity of Treasury securities	December 28, 1962	November 27, 1963
	(per cent)	
Under 1 year	37	27
1-5 years	44	50
Over 5 years	19	23
Total	100	100

Interest rates rise

Increased demands for funds associated with the business expansion brought upward

Short-term interest rates rose sharply in second half of 1963 to highest levels since early 1960



pressure on interest rates. This pressure was reinforced by an increase in the Federal Reserve discount rate to 3½ per cent in July. The discount rate had been 3 per cent since mid-1960—the longest time span without a change in the postwar period. The increase was attributed primarily to the need to reduce short-term capital outflows from the United States by raising domestic short-term interest rates. To minimize the impact of this action on longer-term rates—which are widely believed to be more important than short-term rates in influencing domestic spending decisions—the ceiling on time deposit interest rates was raised to encourage time deposit growth. This in turn enabled the banking system to provide a greater supply of long-term funds and exert downward pressure on long-term rates.

Interest rates on 90-day Treasury bills rose sharply during the year, especially in the second half when they reached levels above the three preceding years. Rates on long-term

Treasury bonds also rose, but more moderately than the bill rate.

Although modified somewhat by effects of the change in the ceilings on time deposit interest rates and occasional Federal Reserve and Treasury purchases of long-term securities, the change in the structure of interest rates was consistent with the pattern that generally prevails in periods of heightened loan demand and expanding business activity. Short-term rates frequently rise more rapidly than long-term rates, with the spread between the two narrowing or even becoming negative.

Other interest rates showed similar trends. At the end of the year, rates on Aaa tax-exempt obligations of state and local governments averaged 3.11 per cent, compared with 2.94 per cent at the beginning of the year—a low for the period since 1958. Rates on prime corporate bonds climbed from 4.22 per cent to 4.37 per cent.

Margin requirements raised

In another policy action in 1963, the Board of Governors of the Federal Reserve System early in November raised the margin requirements on loans for the purchase and carrying of listed stocks from 50 per cent to 70 per cent, thereby lifting from 30 to 50 per cent the proportion of purchase price provided by share buyers. The action was taken "for the purpose of preventing excessive use of credit for the purchase and carrying of securities." Stock market credit had expanded 43 per cent since the reduction in margin requirements from 70 to 50 per cent in July 1962.

Farm economy slows

THE FARM ECONOMY experienced a slight setback in 1963 after three years of general improvement. Despite an increase in total receipts, net farm income last year declined to 12.3 billion dollars from 12.6 billion in 1962, according to recent U. S. Department of Agriculture estimates. A record volume of farm marketings and a continued high level of Government payments more than offset the lower prices that prevailed during much of the year on many farm commodities and boosted gross farm income to an estimated record 41 billion dollars. Net farm income, nevertheless, was diminished by a rise in production expenses, reflecting further increases in the prices of most supplies purchased by farmers and a continuation of the trend of higher taxes and wages.

Cattle prices, under pressure from heavy supplies, were relatively low throughout most of 1963. Prices of choice slaughter steers at Chicago reached a low of $22.61 per hundred pounds in May—well below the year-earlier level and substantially lower than the January price. When cattle prices declined during the spring, a number of cattle feeders delayed marketing their animals in the hope that prices would recover. Subsequently, many of these cattle were marketed at heavier weights. Prices remained under pressure from heavy supplies during the remainder of the year and cattle feeders incurred the added expense of feeding to extra heavy weights. In these circumstances, returns for most feeding programs were below the average of the past 11 years and many Corn Belt farmers sold top-quality cattle at substantially less than the cost of the feeder animals plus the value of the feed. As a result of these losses in the past year—together with the lack of any firm basis for optimism about fat cattle prices in 1964—Corn Belt feeders were reluctant to buy any sizable volume of feeder animals at the prices prevailing in the fall. Inshipments of feeders to the Corn Belt states during the fall months of 1963 averaged about 15 to 18 per cent below the year-earlier numbers.

Hog producers fared somewhat better than cattle feeders in 1963, but their incomes were also below 1962 levels. Pork production expanded about 3 per cent for the year as a whole, boosting per capita supplies to nearly 65 pounds—the highest since 1960. Large numbers of hogs were slaughtered during March and April—up 5 and 12 per cent, respectively, from a year earlier. Prices during these two months dropped to the lowest level since early 1960. Responding to the smaller seasonal supplies during the summer months, prices rose to $19.75 at Chicago in July but again declined as commercial slaughter rose well above 1962 levels during the remainder of the year.

While hog prices averaged well below the year-earlier level, corn prices (the major hog feed ingredient) averaged well above last year, resulting in the lowest hog-corn price ratio since the highly unfavorable year of 1959. In response to the less favorable ratio, farmers scaled down plans for 1964 production. About 6 per cent fewer sows were bred to farrow from September through November than a year ago and about 4 per cent fewer from December through February. These farrowings will make up the bulk of the hogs marketed during the first half of 1964.

Dairy farmers, predominant in Wisconsin and Michigan, experienced somewhat lower incomes in 1963, reflecting a continued upward trend in production costs and slightly reduced prices for dairy products. Production for the year exceeded consumption, but by a smaller amount than in the preceding year. Government purchases dropped nearly one-fourth from the record take-over of nearly 11 billion pounds of milk equivalent in 1962.

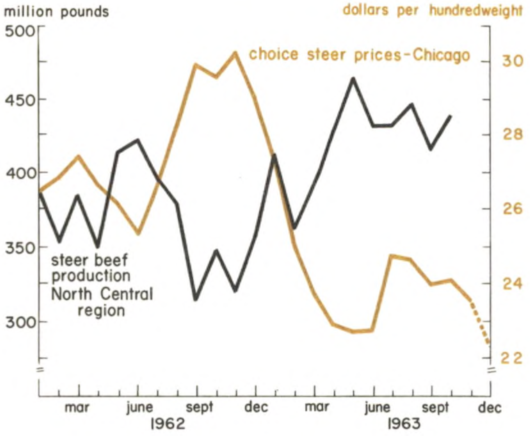
Both reduced milk production and increased consumption of dairy products contributed to the narrowing of the "surplus gap." Total milk production declined about 1 per cent from the record 125.9 billion pounds a year earlier. This smaller total output primarily reflected adverse weather which resulted in poor pasture conditions and short feed crops in some areas as well as a steepening of the downward trend in dairy cow numbers.

The number of milk cows has been declining for many years but output per cow has been rising. At midyear the number of milk cows in the United States totaled 16.6 million or about 3 per cent below a year earlier—the largest decline since 1959. It was also the first year since 1959 that the increase in milk output per cow did not more than offset the loss in output represented by the cows removed from production. Per cow milk production averaged about 160 pounds more than a year earlier, but this was about 23 pounds less than the average yearly increase per cow in the previous decade.

Crops set record

Crops provided the bright spot in Midwest agriculture. Record production was harvested and prices received for many grains were the highest in a number of years. The Government's feed grain program was continued in 1963. Provisions of the program generally followed those applied to the 1961 and 1962 crops but with several important changes: introduction of compensatory payments, re-

Large beef production drives prices lower



duction in payments on diverted acres for most farmers and higher price supports.

Corn, barley and grain sorghum price supports were provided by loans plus compensatory payments while in 1961 and 1962 support was provided entirely by loans. The compensatory payment for corn, for example, was 18 cents per bushel on the normal yield of the planted acreage and was paid regardless of the use of the feed grain—whether fed to livestock, marketed or placed under price support loan. Price supports were increased from the 1962 levels but because of the introduction of the compensatory payments, price support loans on corn, barley and grain sorghum were considerably lower.

Payments for idled acreage were also reduced in 1963. Farmers who idled 20 per cent of their feed grain acreage received payments of about 25 cents per bushel on the normal production of the diverted acres. In the two previous years the payment rate was about 60 cents per bushel.

During the past three years, farmers reduced their feed grain acreage well below the 1960 level through participation in the feed grain program. In 1963, 25.7 million acres were set aside under the program compared with 28.2 million idled in 1962. Acreage planted to feed grains in 1963 was about 3 per cent above 1962 but 14 per cent below the 1960 level. Nevertheless, feed grain production this year was 9 per cent above a year earlier and slightly higher than the 1960 output; favorable weather throughout most of the major crop production regions together with continued application of improved farming practices boosted yields per acre to new highs.

Feed grain prices rose sharply from 1962, reflecting a generally strong demand and a tightening of "free" supplies of corn and sorghum grain. Prices received by farmers for corn advanced to $1.21 per bushel in September, 17 cents higher than 1962 and 1 cent above the support level. This was the highest cash price received for corn in six years.

The little yellow bean

The "heartland" of soybean production lies in the five Seventh District states, which account for more than half of the nation's total output. Relatively attractive soybean prices and acreage allotments and less favorable prices for some other crops during 1963 worked to continue the shift to soybeans that began in preceding years. Farmers in the Seventh District states boosted acreage planted to soybeans by more than 300,000 acres last year and several southern states—where cotton allotments were reduced—also recorded large increases in soybean acreage.

Nationally, acreage alloted to soybean production rose from 27.9 million acres in 1962 to a new record of 29.1 million acres in 1963. Favorable weather, in addition, boosted yield per acre to 24.5 bushels—only slightly below the record high in 1961. As a result, soybean production rose to 701 million bushels, 5 per cent above the 1962 total.

Soybean prices averaged above year-earlier levels during 1963. Prices received by farmers in November averaged $2.66 per bushel, 36 cents higher than the 1962 price and well above the support rate of $2.25. This, of course, reflected the strong foreign demand and the increased rate of domestic consumption that was attributable primarily to the larger numbers of livestock and poultry produced last year.

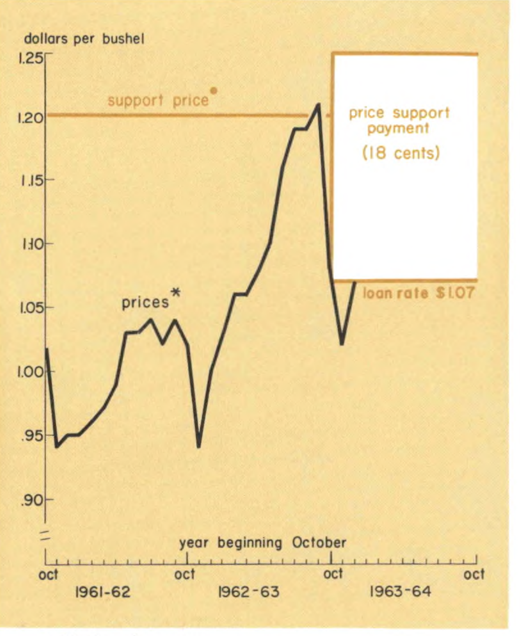
Foreign trade at high level

Exports continued to be an important outlet for United States farm products in 1962-63; commodities equal to nearly 16 per cent of the total agricultural production in 1963 moved into foreign trade channels. Total exports were maintained above the 5 billion dollar level although they declined slightly from year earlier. Commercial sales for dollars, however, totaled about 3.5 billion dollars and exceeded sales for the preceding fiscal year. The slight decline came in exports financed by Government grants and aid.

The high level of agricultural exports was achieved despite the month-long dock strike that began at the end of 1962, unusually cold winter weather that impeded lake and river movements and tightening of import restrictions abroad.

Expansion in commercial exports took place in commodities especially important to Midwest agriculture—chiefly feed grains and soybeans. Exports of soybeans jumped to 171 million bushels from 147 million in the previous year and exports of feed grains—of which about 88 per cent represented sales for dollars—advanced to 16.9 million tons, exceeding the record set in 1962. Feed grain exports to the Common Market countries

Corn prices pierce support level in late 1963



• National average.
* Monthly average received by farmers.

were up substantially even though trade restrictions reduced total exports to that area. Poor crops in parts of Europe, reduced availability of feed grains from other exporting countries and expansion of livestock production in Western Europe and Japan were primarily responsible for the gain.

Credit needs expand

Farmers continued to use larger amounts of credit to help finance machinery purchases, transfers of land ownership and other investments that reduce their requirements of labor as well as facilitate the expansion of livestock herds and the purchase of feed, fertilizer and other supplies. Bank loans to farmers in the Seventh District rose sharply in 1963: at mid-year, loans secured by farm mortgages were up 16 per cent and short-term non-real estate loans were up 17 per cent above year earlier.

Other institutional lenders had recorded sizable increases in loan volume through mid-fall. Foreclosures and delinquencies of interest and principal payments continued at very low levels in 1963. Loan extensions and renewals of non-real estate loans, however, were somewhat higher in some of the cattle feeding areas.

Farmers apparently added to their financial reserves in 1963—savings and other time deposits at country banks continued the rise of previous years despite the lower income received by many farmers. Demand deposits were also above a year ago.

Farm real estate prices resumed their upward movement in the summer and fall of 1963 after an indicated interruption in the long-run trend at the end of 1962. On October 1, 1963, the value of "good" land in the Seventh District was about 3 per cent above the year-earlier level. Consolidation of farms into larger economic units continued during 1963 as farmers on small inefficient units providing inadequate returns sought higher incomes elsewhere. Sales of farmland declined about 3 per cent from 1962 to the lowest level in nearly 30 years. Fewer farms for sale together with the increased number of farmers seeking land for farm enlargement appear to be the major factors supporting the current price structure in the farm real estate market.

International developments in 1963

HOPES WERE STRONG as 1963 began that the relatively slow movement in the preceding two years toward solution of the *balance of payments problem* of the United States would speed up. It soon became apparent, however, that without some new instruments of policy —as well as more vigorous use of existing ones—the payments deficit for the year would exceed the 1962 dollar imbalance.

What developments during the first half of 1963 caused a further deterioration of the United States payments position? One was the large amount of long-term capital outflow as foreign issuers of dollar bonds availed themselves of New York's unexcelled facilities for raising large amounts of money at a cost comparing favorably with foreign capital markets. Between January and June 1963, portfolio investments abroad by American corporations and individuals were at an annual rate of 2 billion dollars, twice as great as in 1962.

Another factor was that higher interest returns on short-term investments abroad continued to attract American funds, further enlarging the deficit on capital account. Meanwhile, little further improvement was achieved by efforts to boost American exports relative to imports, and for the first three quarters of 1963 the merchandise trade surplus was about the same as a year earlier.

With some likelihood that the 1963 deficit in the balance of payments might exceed the record 3.9 billion dollars in 1960—thus belying the most gloomy predictions—there was some danger of enlarged outflows of gold. Accordingly, the President in mid-July presented to Congress a comprehensive program to improve this country's payments position. This was only days after the Federal Reserve had raised the discount rate from 3 to 3½ per cent and maximum permissible interest rates on bank time deposits had been boosted. Both measures were intended to check the short-term capital outflow.

The remedies proposed in the President's message constituted a many-sided attack on the deficit, and while some were capable of yielding results almost immediately, others (for instance, cutbacks in military expenditures abroad) could be expected to bear fruit only slowly. Conspicuous among the former was a proposed interest equalization tax on the purchase by Americans of specified foreign securities.

Uncertainty surrounding the character and timing of congressional action on the proposal effectively closed the door in New York to most prospective foreign issues of new long-term securities and slowed transactions considerably between foreigners and Americans in outstanding issues. Another important element contributing to the sharp improvement in the balance of payments in the third quarter was a decline in short-term bank credit extended to foreigners.

Although results in the fourth quarter may have been somewhat less encouraging than in the third quarter, the balance of payments deficit for the year as a whole—not counting extraordinary receipts such as prepayments of foreign governmental debts and sales of nonmarketable U. S. Government securities abroad—probably was slightly less than the similarly calculated deficit for 1962. This annual comparison, of course, conceals the big swing in the deficit between the first and second half of 1963 due to the improved capital account.

What *merchandise flows* underlie the lackluster performance in the current account? For the first three quarters of 1963, United States merchandise imports were at an annual rate (seasonally adjusted) of 17 billion dollars, about 4 per cent higher than in 1962. During the same period, nonmilitary merchandise exports were at a 22 billion dollar annual rate (seasonally adjusted), 3 per cent ahead of the pace from January to September 1962. This limited expansion on both sides of the trade ledger occurred on a broad front and was not strikingly large in any major commodity category.

Geographic shifts in foreign trade

Exports to Latin America declined slightly during the first three quarters of 1963 from the January to September 1962 total. Shipments to Canada rose nominally during this period, to Western Europe moderately and to other areas even more. On the import side, purchases from Latin America were nearly the same as in 1962, while buying from the other principal regions was up—by less than average from Western Europe, about average from Canada and above average from other areas.

The United States was able to enlarge its export surpluses with Western Europe and other areas but the export surplus with Canada shrank and the import surplus with Latin America rose. Some of these changes in the United States trading position reflect aftereffects of the devaluation of the Canadian dollar in 1962 and inflationary cost and price rises under way recently in such countries as France and Italy.

The United States merchandise export balance would have been smaller but for a substantial increase in authorizations for export credits by the Export-Import Bank, which resulted from activities of the Foreign Credit

[1]See *Business Conditions,* May 1963. The FCIA, an association of more than 70 insurance companies, began operations in February 1962, in collaboration with the Export-Import Bank.

Insurance Association.[1] In January 1963, the FCIA's program was enlarged to include policies covering political risks, which are carried fully by the Export-Import Bank.

Great Lakes ports

On a regional level, commodity movements to or from overseas through midwestern ports in some cases reflected, in magnified fashion, the rise in both United States exports and imports.

Through September of the 1963 season, the port of *Chicago* accommodated a 13 per cent rise in export cargo and an 11 per cent rise in imports as compared with the corresponding months of 1962. Most of the tonnage gain in 1963 was in general rather than bulk cargo. Grain exports through the port to Canada, which are not included in the above percentage figures, were up sharply—45 per cent.

The port of *Detroit* in 1963 increased its exports 6 per cent from 1962 and its imports 43 per cent for a combined gain of 22 per cent. Movements of general cargo were up 28 per cent.

Although traffic through the St. Lawrence Seaway reached the highest figure of record and is expected to exceed 30 million tons for the first time, the port of *Milwaukee's* 1963 trade was somewhat spotty. Export-import tonnage in the general cargo class increased 2 per cent, while bulk grain exports declined 6 per cent and iron and steel scrap shipments ceased. Combined export and import tonnage fell 9 per cent from 1962.

Currency markets

In *foreign exchange markets,* the prices of most major currencies have continued above par against the dollar, but their movements have not been uniform. Some gained additional strength, others weakened and a third group showed little change on balance.

The German mark and the Swiss franc were generally in strong demand, but the Italian lira weakened. The Italian authorities intervened, however, maintaining the rate above par in spite of moderately large reserve declines. French francs, in 1962 already quoted at the highest possible dollar rate (that is, the upper intervention point) permitted by the rules of the European Monetary Agreement—continued in 1963 to move at, or very close to, the ceiling. Sterling lost ground but responded readily to stabilizing intervention by the monetary authorities.

Aside from the Japanese yen (which in 1963 suffered the largest decline among major currencies in the northern hemisphere), no major currency fluctuated more than the Canadian dollar. Since Canada had been the largest borrower in the United States capital market during the early part of the year, that currency weakened following the announcement of the proposed interest equalization tax. The Canadian dollar strengthened again, however, when U. S. Treasury officials gave assurances that under certain conditions the proposed tax would not apply to Canadian issues.

The network of *currency swap arrangements* initiated in 1962 between the Federal Reserve System and a number of foreign central banks was expanded in 1963 (see *Business Conditions,* July 1963). The total amount of reciprocal credit facilities that could be simultaneously utilized by activating stand-by swaps with 10 foreign central banks and the Bank for International Settlements in Basle, Switzerland, was more than doubled as the amount was increased to 2,050 million dollars. (Toward the end of the year, Japan became the twelfth swap partner of the United States.)

The foreign currencies were drawn upon

only moderately by the Federal Reserve in its operations. The purpose of the swap operations is to keep exchange rate fluctuations within relatively narrow bounds and to avoid a bunching of United States gold losses that may result when foreign central banks accumulate dollars in excess of amounts they wish to hold.

Swap operations, by their very nature, are short-term and an inappropriate instrument for defending the domestic gold stock when dollar accruals by foreign central banks prove to be more than temporary. In order to meet a longer-term need for foreign exchange resulting from continued, but presumably not permanent, market pressures on the dollar, the U. S. Treasury in 1963 sold several hundred million dollars of nonmarketable intermediate-term bonds denominated in foreign currencies.

Dollar problem persists

As the year drew to a close, there was a note of optimism regarding the balance of payments outlook. Only a much more sustained improvement, however, would suggest that the dollar drain problem had been solved. To relax efforts toward a further reduction of the deficit might well be premature since there is little assurance thus far on at least two important points. For one, how long will the capital outflow from the United States remain at the recent low level—which is attributable largely to uncertainty over the interest equalization tax proposal? Second, if and when the income tax reduction bill is passed, will a rise in imports induced by a resulting increase in disposable income serve to narrow the present export surplus? And how far will such a rise be offset by a reduction in outflow of equity capital, owing to improved profit expectations at home?

Since the United States dollar is a reserve currency *par excellence,* a reduction in the American deficit would lead to a smaller rise in world payments liquidity. At the annual meeting in September of the International Monetary Fund (IMF), which now has more than 100 members, two comprehensive studies of the international payments system were initiated. One is being conducted by the IMF staff, the other by Treasury representatives of the 10 major IMF members that participate in the General Arrangements to Borrow, a relatively recent innovation.

Results from these studies are not expected before the latter part of 1964. Regardless of the nature of recommendations that may be forthcoming, removal of the imbalances still existing in the external accounts of the United States and a few other major countries is regarded as by far the most important near-term objective.